Supreme Court, U.S.
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No.

IN THE

Supreme Court of the United States

LABORERS NATIONAL PENSION FUND, an employee pension benefit plan, BILL HARBERT, Trustee; ARTHUR A. COIA, Trustee; BRUCE HUGHES, Trustee; R.P. VINALL, Trustee; ROBERT D. SHEEHAN, Trustee; MASON M. WARREN, Trustee; BILLY L. HARBERT, JR., Trustee; and CARL E. BOOKER, Trustee,

Petitioners,

v.

AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO, a corporation; NORTHERN TRUST QUANTITATIVE ADVISORS, INC., a corporation; and THE FIRST NATIONAL BANK OF CHICAGO, a corporation,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Whether the Fifth Circuit erred by establishing a purely procedural test for reviewing an ERISA fiduciary's investment decisions that conflicts with other circuits' tests, which inquire into the substantive merits of the investment decision?

2. Whether the Fifth Circuit erred by expanding the scope of the "modern portfolio theory" standard to supersede specific provisions of an ERISA plan that govern a portion of the plan's entire portfolio consistent with ERISA's policies.

3. Whether the Fifth Circuit erred by reviewing the record *de novo* and applying its own factual findings to a newly announced legal standard?

PARTIES TO THE PROCEEDING

The parties are listed in the caption of the case, pursuant to Rule 14(b). Concerning the Trustees, Petitioners note that Arthur A. Coia is no longer a Trustee, R.P. Vinall and Robert D. Sheehan are deceased, and J. Tom White is now a Trustee.

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STATEMENT OF JURISDICTION

The judgment of the Fifth Circuit is dated April 16, 1999. (Appendix A). The order denying Petitioner's petitions for panel rehearing and rehearing en banc is dated June 16, 1999. (Appendix C). The statutory provision conferring jurisdiction to review the judgment is 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The case concerns Section 404(a)(1) of the Employment Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. § 1104(a)(1), and regulations promulgated under that provision by the Department of Labor, 29 C.F.R. § 2550.404a-1, relevant portions of which are included as Appendix D.

STATEMENT OF THE CASE

This case involves a breach of fiduciary duty under ERISA. The investment managers of an ERISA employee pension benefit plan invested millions of dollars of the plan's fixed income assets in high risk interest-only collateralized mortgage-backed securities ("IOs") in violation of the plan's investment guidelines and ERISA's "prudent" man standard of care. As a result of the IO investment, the plan suffered a significant loss of principal.

To recoup its losses, the plan's trustees sued the investment managers in federal district court and prevailed after a full trial on the merits. On appeal, however, the Fifth Circuit reversed and rendered judgment against the plan. In doing so, it improperly announced a new legal standard for ERISA that conflicts with the ERISA law of other circuits, and reweighed conflicting evidence under a *de novo* standard of review.

The trial. As shown at trial, Laborers National Pension Fund (the "Fund") was established in 1968 to provide retirement income for its beneficiaries, currently about 15,000 construction industry retirees and beneficiaries. In 1971, the Fund's Trustees — volunteers drawn from the rank and file of current and retired employees and executives from employers contributing to the Fund — hired American National Bank and Trust Company of Chicago ("ANB") to manage a portion of the Fund's portfolio. ANB served in that managerial role until 1994, after significant losses from the IO investment came to light.

The relationship between the Fund and ANB was governed by an investment management agreement, which allowed ANB investment-making discretion limited by "the framework of an investment policy approved by the trustees." The Trustees repeatedly informed ANB of their "very low tolerance for risk of loss to principal, particularly with regard to fixed income investments." In fact, as early as 1975, the Trustees required (by contract) ANB to report any losses of 10% or more on any particular security. The Trustees classified investments as "fixed income" investments and "equity" investments. Each category was to be managed according to different guidelines due to their different purposes within the Fund's entire portfolio.

In 1976, in light of ERISA, the Trustees created a written set of investment guidelines, reflecting their conservative policy with respect to fixed income investments. Fixed income investments had to fall within one of two classes: (1) federal or federal agency obligations; or (2) corporate bonds of the highest three quality grades. The Fund relied upon ANB's expertise to keep the guidelines updated in accordance with the Trustee's investment philosophy.

The securities at issue in this case, IOs, were created in the late 1980's. IOs are exotic and extremely risky financial instruments. Details about IO derivatives are provided in the footnote below, but it suffices to say that they pose a unique, irreversible risk to the principal of an investment, based on interest rate fluctuations; they are not federal or federal agency obligations or corporate bonds of the first three quality grades.[1] Nevertheless, ANB purchased IOs for the Fund's fixed income account.

The Trustees knew nothing about IOs when ANB purchased them, and ANB did not disclose the risks

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1. Collateralized mortgage-backed securities group mortgage obligations from thousands of homeowners together into one pool. IO strips represent a right to receive a portion of the interest paid on a stream of those mortgages. The right to receive a portion of the principal payments made to repay the mortgages is separated from the interest-only strips. When mortgages are prepaid by the borrowers, the yield of the IO strips is reduced. If interest rates decrease, people tend to refinance their mortgages, thereby extinguishing part of the interest-only income streams. *See* App. A at 3a-4a; App. B at 26a-27a. These characteristics create unique risks for investments in IO derivatives. The Fifth Circuit incorrectly stated that IOs are graded within the top three quality grades of risks. While the underlying mortgages may be federally guaranteed, the interest payments and interest streams are not. *See infra* Section Vb.

associated with IOs to the Trustees before investing $11 million in the securities. Indeed, the district court found that the person at ANB who handled the account, Tom Pierce, failed even "to consider the investment guidelines or whether IOs would violate the spirit of those guidelines." Mr. Pierce disregarded the Trustees' wishes because he did not believe that clients could adequately assess their own needs or make decisions. Moreover, ANB did not disclose the losses resulting from the IO investment, as required by its contract with the Fund.

At trial, ANB claimed it bought IOs as an interest rate "hedge," but the district court flatly rejected that *ex post* rationalization based on the evidence, testimony, and credibility of the witnesses at trial. Instead, the district court found that the IO investment was really an interest rate gamble, as Mr. Pierce "was convinced" that interest rates would continue to rise. At the trial's conclusion, the district court found that ANB's investment in the IOs constituted a breach of its fiduciary duties and a violation of ERISA's prudent man standard of care. The district court accepted the Fund's expert's testimony concerning damages and also awarded attorneys' fees and costs.

The Fifth Circuit's Decision. In a published opinion, the Fifth Circuit crafted a new legal standard for evaluating the conduct of ERISA fiduciaries under the prudent man standard, which effectively insulates ERISA fiduciaries from liability — as a matter of law — if they follow a simple, rote procedure, regardless of fact-specific ERISA-plan documents and the lack of prudence in the investment decision.

In applying its new standard, the Fifth Circuit rejected the district court's factual findings and re-evaluated the

evidence in light of that standard, rather than remanding the case to the district court. The Fifth Circuit accepted the veracity of Mr. Pierce's testimony at face value and discarded the district court's credibility determinations and finding that Mr. Pierce failed to consult the Fund's investment guidelines. Furthermore, the Fifth Circuit re-evaluated the Fund's investment guidelines in light of its new interpretation of the prudent man standard, which displaces the ability of ERISA plans to comprehensively manage their investments with investment managers and purposes through plan documents, and which conflicts with ERISA's express statutory language. 29 U.S.C. § 1104(a)(1)(D).

REASONS FOR GRANTING THE WRIT

This Court should grant this Petition for Certiorari under United States Supreme Court Rule 10(a) and (c), because: (1) the Fifth Circuit has decided this case in a way that conflicts with other circuits; (2) the Fifth Circuit has so far departed from the accepted and usual course of judicial proceedings to call for an exercise of this Court's supervisory powers; and (3) the Fifth Circuit has decided an important question of federal law that has not been, but should be, settled by this Court, and the implications of the Fifth Circuit's holding conflicts with prior holdings of this Court.

I. THE FIFTH CIRCUIT IMPROPERLY HELD THAT THE SUBSTANCE OF AN INVESTMENT DECISION BY AN ERISA FIDUCIARY IS IRRELEVANT TO THE "PRUDENT MAN" INQUIRY, SO LONG AS A SIMPLE PROCESS IS FOLLOWED.

An ERISA fiduciary's conduct is evaluated in light of the "prudent man" standard of care. This standard requires a fiduciary to act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matter would use in the conduct of an enterprise of a like character with like aims." 29 U.S.C. § 1104(a)(1)(B). With respect to investments, the prudent man standard subsumes two, distinct duties: (1) a duty to follow a sound decision-making process; and (2) a duty to make a sound decision on the substantive merits of a particular investment, or, in other words, to choose an investment wisely. *See Lynch v. J.P. Stevens & Co.*, 758 F. Supp. 976, 1013 (D.N.J. 1991) (recognizing duty to investigate merits of investment independent from duty to invest prudently) (citing *Fink v. National Savings & Trust Co.*, 772 F.2d 951, 962 (D.C. Cir. 1985) (Scalia, J., concurring in part and dissenting in part)); *Whitfield v. Cohen*, 682 F. Supp. 188, 194-95 (S.D.N.Y. 1988). In this case, the Fifth Circuit has collapsed these two related, yet independent, obligations into a single procedural test that allows imprudent decisions to go unchecked on review, and that disregards specific ERISA plan documents.

The inquiry into the substantive merits of a decision is a necessary first step in evaluating any fiduciary's conduct. The Fifth Circuit omitted this crucial aspect of reviewing fiduciary conduct through its confusion of the role of the

"common law of trusts" and the "modern portfolio theory" standards under ERISA. Initially, courts imported the standards from the common law of trusts into ERISA jurisprudence when reviewing investment decisions. *See Donovan v. Cunningham*, 716 F.2d 1455, 1464 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984) (recognizing that core principles of ERISA fiduciary conduct were developed in the common law of trusts). Under trust law, each investment was reviewed on its own merits in isolation, to determine whether the fiduciary complied with its duty of care. *See, e.g., In re Bank of New York*, 323 N.E.2d 700, 703-04 (N.Y. 1974).

Pursuant to its powers under ERISA, however, the Department of Labor changed the standard of review from the common law doctrine to the "modern portfolio theory," as described in 29 C.F.R. § 2550.404a-1. *See* 44 FED. REG. 37222 (June 12, 1979) (The "prudence" rule in [ERISA] sets forth a standard built upon, but that should and does depart from, traditional trust law in certain respects."). Under this standard, courts examine an individual investment in the context of a portfolio. *See* B. MARCUS, THE PRUDENT MAN: MAKING DECISIONS UNDER ERISA 34 (1978) ("It is . . . the position of the Labor Department, that under . . . ERISA, the prudence of any investment for a pension plan should be judged in relation to the role which the proposed investment is to play in the portfolio.").

The district court fully understood and applied the "modern portfolio theory" standard of review when it found that the very decision to buy IOs in the fixed income account was unwise and imprudent — on both an objective basis and in the context of the Trustees' instructions for fixed-income investments for the Fund. The evidence showed that the

merits of the decision to invest in IOs fell below ANB's duty of care as a fiduciary. The portfolio at issue included the fixed income portfolio. In addition to concerns about the process of reaching the decision, the district court did not lose sight of the crucial principle that the substance, not merely the process, of the decision is important in evaluating a fiduciary's conduct. *See Fink v. National Savings & Trust Co.*, 772 F.2d 951, 962 (D.C. Cir. 1985) (Scalia, J., concurring in part and dissenting in part).

However, the Fifth Circuit rejected this principle and claimed that the district court applied the common law of trusts, instead of the modern portfolio theory, when evaluating the prudence of the IO investment. To support its conclusion, the Fifth Circuit pulled one sentence from the district court's decision out of context — "[i]t does not matter that other investment consultants in the industry held the opinion that IOs were appropriate for modern investment portfolios or that the portfolio as a whole made an adequate return." ANB argued, in large part, that other investment managers invested in IOs and therefore ANB's purchase decision was permissible. The district court properly rejected that argument — after all, the mere fact that other investment managers bought IOs based on their own internal procedures or their beneficiaries' plan documents does not render the investment in this case prudent under any standard. Moreover, the fact that an entire portfolio fared well should not immunize individual imprudent investments from review.

Rather than consider the specific circumstances relating to ANB and the Fund and deferring to the district court's evaluation of the conflicting testimony about the prudence of buying IO securities here, the Fifth Circuit merely created a laundry-list of procedures that, if followed, will allow any

investment decision to pass muster under the Fifth Circuit's interpretation of the modern portfolio theory. The Fifth Circuit exonerated ANB because it found, in the first instance, that the following steps were taken (and were sufficient as a matter of law): (1) consultation with ANB documents that purportedly incorporated the Fund's guidelines; (2) review of "general literature" and discussions with brokers; (3) utilization of Bloomberg stress simulations; and (4) consideration of other fixed income alternatives. This brief, four-step procedural test conflicts with the crucial substantive duties of care imposed on ERISA fiduciaries and undermines the importance of reviewing the merits of particular investments. (The substantive duty of care is different in kind from the duty to investigate a potential investment.) Moreover, it is neither consistent nor coextensive with the Department of Labor's regulations or the modern portfolio theory, and it cannot replace express limitations of an ERISA plan's documents or contracts. (As discussed in detail in Section V, the Fifth Circuit failed to remand the case to the district court for an examination of the evidence under this new procedural standard, and the record shows that, even under these criteria, ANB breached its duty of care.)

The Fifth Circuit's decision weakens the protections of ERISA, threatens pension beneficiaries, and conflicts with the broad remedial purposes of the statute. Not only was the Fifth Circuit wrong as a matter of law, but the published decision endangers future review of ERISA fiduciary conduct — especially in light of the present bull market. If courts simply look to overall returns on entire portfolios only, losses attributable to even grossly negligent investments will go without redress, based on the performance of other holdings in the entire portfolio. In addition, these steps fail to give

weight to plan documents and the purpose of specific investments.

The Fifth Circuit's opinion has also created a conflict in the circuits, as other courts around the country still examine the merits of investment decisions and have found IOs imprudent despite internal procedures followed by ERISA fiduciaries before making the gamble. For instance, in *Harley v. Minnesota Mining & Mfg. Co.*, 42 F. Supp.2d 898 (D. Minn. 1999), the United States District Court for the District of Minnesota found that even though the fiduciary of a pension plan claimed to have investigated collateralized mortgage obligations ("CMOs") similar to IOs for approximately one year before investing in them, a reasonable fact finder still could find that the investment was objectively imprudent under ERISA. *See Harley*, 42 F. Supp.2d at 909. Similarly, in *Liss v. Smith*, 991 F. Supp. 278 (S.D.N.Y. 1998), the United States District Court for the Southern District of New York found that, even though the pension fund trustees had not conducted a proper investigation into the CMO investment, the separate issue of whether the investment was objectively prudent or imprudent still had to be considered. *See Liss*, 991 F. Supp. at 297 n.22.

II. THE FIFTH CIRCUIT SUBORDINATED THE ERISA PLAN'S SPECIFIC GUIDELINES TO GENERAL LEGAL PRINCIPLES BY IMPROPERLY EXPANDING THE SCOPE OF THE MODERN PORTFOLIO THEORY.

The Fifth Circuit's decision casts doubt on all ERISA plan documents and their stated goals and creates instability in established ERISA fiduciary relationships. ERISA

fiduciaries must comply with the plan documents and instruments, including investment guidelines established by trustees. 29 U.S.C. § 1104(a)(1)(D); *see also Faircloth v. Lundy Parking Co.*, 91 F.3d 648, 656 (4th Cir. 1996), *cert. denied*, 519 U.S. 1077 (1997); *Dardaganis v. Grace Capital, Inc.*, 889 F.2d 1237, 1241 (2d Cir. 1989); *Donovan v. Cunningham*, 716 F.2d 1455, 1468 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984). However, the Fifth Circuit held that, in the event of a conflict between the regulations and the plan documents — regardless of whether the plan documents are consistent with ERISA's policies — the regulations prevail over the plan. *See* App. A at 18a. Not only is this holding legally incorrect, but it endangers ERISA plans, as demonstrated by this case.

The Trustees constructed a comprehensive strategy for managing the Fund's money. They divided the entire portfolio of assets into two basic categories — equity and fixed-income holdings. In this manner, the Trustees could pursue different goals through different types of investments and thereby protect their beneficiaries' interests. Equity holdings were intended to carry greater potential risks and rewards, while fixed-income holdings were intended to be more stable, with a lower risk to reward ratio.

Despite the guidelines for fixed income investments, ANB invested millions from the fixed-income account in IOs. The Fifth Circuit exonerated the investment by stating that courts must look to the entire portfolio and "universe" of holdings when reviewing the fiduciary's decision. But it is not proper to review fixed-income investments using the same criteria for equities or other investments, which have different purposes and which are governed by different ERISA plan documents. To do so erases the plan documents

and destroys the comprehensive and coherent organization of ERISA plans everywhere in the Fifth Circuit. The decision creates a legal conflict between the objectives and instructions found in plan documents on the one hand, and general ERISA principles such as the "modern portfolio theory" on the other. While arguably no conflict between the plan documents in this case and the Department of Labor's regulations existed here, the appellate court chose to disregard the Fund's express guidelines and investment strategy, only to replace them with the "modern portfolio theory" applicable to all investments generally. Rather than consider the specific fixed income portfolio at issue, the Fifth Circuit broadened its scope to the Fund's entire investment portfolio managed by ANB.

III. THE FIFTH CIRCUIT CREATED A NEW LEGAL FLOOR FOR EVALUATING ERISA FIDUCIARIES.

The Fifth Circuit's decision is especially dangerous because it devalues the care that ERISA plan trustees put into organizing and managing investments through specific plan documents and streamlines review to a single checklist identical for all plans, rather than the fact-specific inquiry previously required. By accepting ANB's testimony at face value and setting up a procedural checklist as a standard, the Fifth Circuit not only has immunized decisions to buy IOs and other unsafe investments (in stark contrast to other circuits), but it has also usurped the role of the Department of Labor for promulgating regulations to govern and guide ERISA fiduciaries. *See also Roth v. Sawyer-Cleator Lumber Co.*, 16 F.3d 915, 918 (8th Cir. 1994) (court refused to adopt checklist-type of procedure for satisfying fiduciary duty under ERISA because to "[a]dopt this standard would . . .

ignore the trustee's conduct by relieving him of any duty to evaluate whether [his course of action was prudent]").

IV. THE FIFTH CIRCUIT IDENTIFIED A POTENTIAL LEGAL ERROR THAT CALLS FOR ADDITIONAL EVIDENCE AT THE DISTRICT COURT LEVEL.

The Fifth Circuit incorrectly asserted that the district court failed to apply the modern portfolio theory to evaluate ANB's conduct. Modern portfolio theory, which is outlined in 29 C.F.R. § 2550.404a-1, was addressed by the witnesses and experts, and the district court considered the IOs imprudent in light of the portfolio managed by ANB. As explained in Section I above, the Fifth Circuit took one sentence from the district court's factual findings out of context of the surrounding language (and the entire decision) in reaching this erroneous conclusion. *See* App. A at 17a-18a. The decision to reverse and render was improper because: (1) even under the new standard, the evidence still shows that ANB breached its fiduciary duties; and, alternatively, (2) based on the Fifth Circuit's decision that the district court applied the wrong legal standard, the appellate court should have remanded the case for further factual development and application of the legal standard by the trial court in the first instance, rather than engage in *de novo* factual findings and apply the legal standard in the first instance on appeal.

The district court applied the correct legal standard. It expressly considered modern portfolio theory and found that ANB did not act prudently under ERISA's prudent man standard. *See* App. B at 27a-29a. These findings are justified by the evidence and are consistent with ERISA principles.

See Letter of Guidance and Statement on Derivatives, Dep't Labor & OCC (March 28, 1996) (stating that investment manager must evaluate the effects derivatives "will have on the *relevant segments of the plan's portfolio* as well as the portfolio's overall risk") (emphasis added). (The panel's liberal quotation of this letter selectively omits this language. *See* App. A at 8a-9a.). *See also Dardaganis v. Grace Capital Inc.*, 889 F.2d 1237, 1243 (2d Cir. 1989) (holding ERISA plan's increase in total value during fiduciary's tenure did not prevent breach of fiduciary duty finding); Joseph R. Simone & Glenn E. Butash, *Fiduciary Responsibility and Prohibited Transactions under ERISA*, 445 PRACTICING LAW INSTITUTE: TAX LAW AND ESTATE PLANNING COURSE HANDBOOK SERIES 443, 454 (July 1999) (Under modern portfolio theory, "[an investment] should not be deemed to be imprudent because the investment, standing alone, would have a relatively high degree of risk. However, this does not simply mean that a plan investment should be deemed prudent solely by reason of the aggregate risk and return characteristics of the plan's portfolio."). While no findings were made on each of the elements raised by the new standard and in 29 C.F.R. § 2550.404a-1, this error (if any) is legal in nature and should have been cured by vacating the judgment and remanding, rather than rendering judgment at the appellate court level. In that manner, the district court could have issued express findings on the elements raised by the new test and the regulation.

V. THE FIFTH CIRCUIT IMPROPERLY REVIEWED THE FACTUAL RECORD *DE NOVO*.

The Fifth Circuit failed to defer to the district court's factual findings, as required by Federal Rule of Civil Procedure 52(a). Rule 52(a) requires appellate courts to

uphold the district court's factual findings unless they are "clearly erroneous." That standard avoids unnecessary duplication of effort at the appellate level and simple errors (as described below) that undermine confidence in the judicial system. Such deference extends to the trial court's determinations of a witness' demeanor, credibility and inferences from documentary evidence. *See Bose Corp. v. Consumers Union*, 466 U.S. 485, 500 (1984) (discussing special deference due trial court's credibility determinations).

This Court has stated that a trial court's factual findings are clearly erroneous, even where there is some evidence to support them, if, when considering all the evidence, the reviewing court is left with the definite and firm conviction that an error has been made. *See United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948). However, appellate courts may not reverse the district court's findings simply because the reviewing court would have reached a different conclusion in the first instance. *See Anderson v. City of Bessemer City*, 470 U.S. 564, 573 (1985); *Reich v. Lancaster*, 55 F.3d 1034 (5th Cir. 1995). If there are two possible interpretations to be drawn from the evidence, the district court's interpretation cannot be clearly erroneous as a matter of law. *See United States v. Yellow Cab Co.*, 338 U.S. 338, 342 (1949).

The appellate court's function is not to hear evidence *de novo*. *See Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 123 (1969). Not only do the federal rules prohibit *de novo* review, but considerations of fairness to the litigants, who have already expended their energies attempting to persuade the trial court that their version of the facts is correct, also weigh against reconsideration of the facts at the appellate level. *See Anderson*, 470 U.S. at

575; *see also* FED. R. CIV. P. 52(a) (advisory committee notes) (allowing the appellate court to conduct its own factual findings undermines the trial court's legitimacy, increases the number of appeals by encouraging litigants to try cases *de novo* at the appellate level, and needlessly reallocates judicial authority). This Court has stated that a *de novo* review of factual findings occurs when a "reviewing court makes an original appraisal of all the evidence to decide whether or not it believes that judgment should be entered for plaintiff." *Bose Corp.*, 466 U.S. at 514 n.31.

In the case at hand, the Fifth Circuit conducted a *de novo* review of the evidence when reversing and rendering against the Fund. Even though ANB admitted during oral argument before the Fifth Circuit that it did not challenge the district court's factual findings, the Fifth Circuit nevertheless re-examined the record on its own and rejected the district court's factual findings. In doing so, the panel exceeded the scope of appellate review and created, *de facto*, a new legal standard for ERISA fiduciaries.

This case was resolved by a full trial on the merits complete with live testimony and active cross-examination. The appellate court cited, but did not follow, *Reich v. Lancaster*, which stated that appellate courts must defer to the district court's factual findings unless they are clearly erroneous. *See* App. A at 4a (citing *Reich*, 55 F.3d at 1045).

The foundation of the Fifth Circuit's opinion is comprised of several factual conclusions and inferences that expressly conflict with the district court's findings. Nevertheless, the Fifth Circuit failed to consider all of the evidence and did not explain why it was left with the firm conviction that the district court's conclusions were "clearly

erroneous." *See Dennison Mfr. Co. v. Panduit Corp.*, 475 U.S. 809, 811 (1986) (granting petition for certiorari, vacating judgment, and remanding where court of appeals did not provide an adequate explanation for rejecting district court's factual findings). To the contrary, the evidence that convinced the district court that a breach of fiduciary duty occurred shows that both the substantive decision to purchase IOs and the decision making process were not prudent.

In the alternative, the Fifth Circuit was incorrect in holding that the district court's factual findings were clearly erroneous. App. A at 12a. As discussed in detail below, the record contains conflicting evidence concerning whether ANB actually and effectively considered and followed the Fund's guidelines before purchasing the IOs. In addition, the record contains conflicting expert testimony regarding the characteristics of IOs and the prudence of ANB's investment decision. Accordingly, the district court's findings cannot be "clearly erroneous" as a matter of law.

The Fund shows below how critical factual underpinnings of the Fifth Circuit's decision are either wrong or unsound due to conflicting record evidence:

a. *Derivatives were not a hedge.* The Fifth Circuit found that ANB's investment in IOs "was reasonably designed as part of the Fund's portfolio to further the purposes of diversification as a hedge against possible interest rate hikes and consequent declines in values of fixed income securities." App. A at 16a. This squarely contradicts the express finding by the district court that "[t]he evidence does not show that IOs were being used to hedge. Rather, the evidence shows, and the Court so finds, that the IOs were purchased because Mr. Pierce was convinced that interest

rates would continue to rise." App. B at 28a. While the district court understood that IOs "may be properly used to hedge," it evaluated the evidence and credibility of all the witnesses and found that the IOs were *not* used as a hedge in this case. *Id.*

The district court heard sufficient evidence to support its conclusion. ANB's own expert witness admitted that the IOs in this case were not an exact hedge. Mr. Pierce did not testify that the IOs were intended to hedge risk. The Fund's expert witness testified that IOs did not serve any hedging function or protect the portfolio. Moreover, the district court found that other hedging mechanisms without the same risk to principal posed by the IOs were available, demonstrating the substantive imprudence of purchasing IOs and proving that the true motives behind the IO investment was not to hedge (the *ex post facto* rationalization ANB offered), but rather to bet on interest rates in the hopes of a big return. *See* App. B at 28a.

b. *AAA rating.* The Fifth Circuit misunderstood the IOs' purported ratings, in the same way that investors are duped into buying unsafe derivatives. Relying on its conclusion that the pension plan guidelines did not prohibit IO investments "of the first three quality grades," the Fifth Circuit justified the IO purchase decision by stating that the IOs were AAA rated at the time of purchase. *See* App. A at 16a. This statement is misleading, if not simply wrong. The *underlying mortgages* for the derivatives were AAA rated based on their "credit" risk of repayment, which was good because the mortgages themselves were federally guaranteed. However, the IO strips carried a substantial risk to principal that was different in kind from the "credit" risk — a "prepayment" risk to the principal. As discussed above, the

interest payments may be pretermitted if a mortgage is repaid early or refinanced. Thus, any reference to a "AAA rating" associated with IO strips is materially misleading, which is the precise problem with derivatives; they take relatively safe investments and "chop them up" in a way that creates dramatic risk, like that realized by the Fund's pensioners in this case.

c. *Lazard Freres.* Although the Fifth Circuit relied on Lazard Freres' purchase of IOs for the Fund to buttress ANB's IO investment decision, it failed to mention not only that Lazard Freres acknowledged that buying the IOs violated the Fund's guidelines, but also that Lazard Freres came forward, admitted its error, and apologized to the Fund — in stark contrast to ANB, which remained silent about the multi-million dollar loss until the Trustees called them on it. *See* App. A at 13a. That quick exchange in the courtroom, comprising just a few lines in the record, could be easily overlooked by the Fifth Circuit, but was brilliantly eye-opening to the district court (and to ANB's surprised counsel), proving the wisdom of appellate deference on matters of testimony and the pitfalls of appellate fact-finding.

d. *Consistency of IOs with the plan guidelines.* The Fifth Circuit stated that the district court "clearly erred in determining that ANB failed to consider Fund guidelines." *Id.* at 12a. However, the district court presented the reasons for its decision, which were grounded in the trial evidence. First, this finding involved a credibility determination concerning Mr. Pierce's testimony, which the Fifth Circuit should not have second-guessed because it did not see him on the stand. Second, this finding was well-grounded in the plan documents. While the documents do not expressly mention IOs (because no one had yet contrived IOs when

the plan was drafted), and the Fifth Circuit considered the guidelines "ambiguous," the testimony regarding a reasonably competent fiduciary's interpretation of those guidelines shows that ANB should have known that the Fund's conservative philosophy would not tolerate the grave risks inherent in IOs. *See id.* at 14a-15a. Third, the Fifth Circuit's rejection of the district court's findings leads to another incorrect factual conclusion, that "ANB was not required to obtain prior approval" before buying IOs because they were "designed as a hedge and to produce a desirable result for the portfolio as a whole." *Id.* at 17a. As stated above, IOs were a risky new investment that did not exist when the plan was created and therefore were not excluded by name, and the IOs simply were not a hedge in this case.

e. *Expert witness evaluation and credibility.* The Fifth Circuit disregarded the district court's evaluation of expert testimony in this case, even though ANB did not challenge the relevancy or reliability of the Fund's experts' opinions. The Fifth Circuit summarily rejected the testimony, purportedly because the Fund's experts "failed to point out any specific violation by Mr. Pierce or ANB of a fiduciary duty required by the prudent investor and modern portfolio standards of ERISA and the related federal regulations." *Id.* at 19a. This is wrong for two reasons. First, the experts did explain how ANB violated the prudent man standard, as IOs were the riskiest form of mortgage-backed securities and there was no reason for investing in IOs other than believing that interest rates would rise.

Second, these witnesses, who were undeniably experts in the field of investments, securities, and portfolio management, testified about the substantive investment decision, and the wisdom and prudence (or lack thereof) of

investing in IOs — both individually and as part of an investment portfolio. ANB's own expert witness testified that he would not have purchased IOs if, at the relevant time, he had managed the Fund's money in this case, stating that "right thinking investment managers" would not "put a pension fund into IOs." The district court was permitted to consider this evidence in reaching its factual conclusions. Determining whether the testimony was relevant and reliable was within the district court's discretion. *See Khumo Tire Co. v. Carmichael*, 119 S. Ct. 1167, 1176 (1999). Nevertheless, the Fifth Circuit put itself in the role of an expert ERISA fiduciary and investment manager and allowed its opinion to trump those of qualified financial experts whose unchallenged testimony was accepted and properly credited by the district court.

f. *Stress test.* Although Mr. Pierce claims he "stressed" the IOs, ANB and Mr. Pierce could not produce documentation to prove it. In contrast, the Fund proved that Mr. Pierce either conducted the tests improperly or that his results were wrong. The district court was in the best position to evaluate Mr. Pierce's credibility and the conflicting testimony about the stress tests, and the Fifth Circuit wrongly disregarded the record evidence and the district court's role.

CONCLUSION

The Court should grant certiorari to clarify the legal standards governing fiduciaries who handle pension assets for ERISA beneficiaries throughout the country. The Fifth Circuit collapsed the substantive duties of care and prudence into a single procedural test that disregards the merits of specific investment decisions and the particular context of each investment. The Fifth Circuit injected uncertainty into carefully crafted ERISA plan documents and minimized ERISA plans' efforts to structure comprehensive investment strategies to protect the pensions of retired workers. In its eagerness to overturn a substantial judgment in favor of the pensioners, the Fifth Circuit engaged in new factual findings and did not defer to the district court's credibility assessments and findings after a full trial. Accordingly, petitioners pray that the Court grant this petition for certiorari, allow an opportunity for full briefing, reverse the judgment of the Fifth Circuit and reinstate the judgment of the district court, or alternatively remand for further proceedings before the Fifth Circuit or the district court.

Respectfully submitted,

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APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT DATED AND FILED APRIL 16, 1999

UNITED STATES COURT OF APPEALS
For the Fifth Circuit

No. 97-11023

LABORERS NATIONAL PENSION FUND,
an employee pension benefit plan, et al,

Plaintiffs,

BILL L HARBERT, Board of Trustee; ARTHUR A COIA, Board of Trustee; BRUCE HUGHES, Board of Trustee; R P VINALL, Board of Trustee; ROBERT D SHEEHAN, Board of Trustee; MASON M WARREN, Board of Trustee; BILLY L HARBERT, JR, Board of Trustee; CARL E BOOKER, Board of Trustee;

Plaintiffs-Appellees,

VERSUS

NORTHERN TRUST QUANTITATIVE ADVISORS, INC., a corporation; THE FIRST NATIONAL BANK OF CHICAGO, a corporation; AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO, a corporation;

Defendants,

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NORTHERN TRUST QUANTITATIVE ADVISORS, INC., a corporation; AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO, a corporation;

Defendants-Appellants.

Appeal from the United States District Court
for the Northern District of Texas

Before EMILIO M. GARZA, BENAVIDES and DENNIS, Circuit Judges.

DENNIS, Circuit Judge:

The Laborers National Pension Fund (Fund) filed suit against American National Bank and Trust Company of Chicago (ANB) for damages because of breach of fiduciary duties as the Fund's investment manager under the Employment Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001 *et seq*. After a bench trial, the district court determined that ANB's purchase of interest-only mortgage-backed securities (IOs) was not a prudent investment and rendered a money judgment for the Fund against ANB. We reverse and render judgment for ANB.

Factual and Procedural Background

The Fund was established in 1968 to provide retirement income for laborers employed in several southern and central states. It is governed by a volunteer Board of Trustees (Trustees) who represent contributing employers and union officials. From 1971 to 1994, the Fund hired ANB as one of

several investment managers responsible for handling its $1 billion portfolio. The Fund's portfolio has two types of accounts: fixed-income (bonds and mortgage-backed securities) and equity (stocks). In September 1991, ANB invested $11 million of the Fund's fixed-income account in IOs. ANB sold the IOs at a loss for $4.2 million in September 1992. Despite this loss, the portion of the Fund's total portfolio (fixed-income and equity) managed by ANB experienced a positive return of 6 percent for calendar year 1992, generating approximately $18 million.[1]

Interest-only mortgage-backed securities (IOs) were created in the late 1980s. An IO is a right to receive a portion of the interest only from payments on mortgage loans. Each IO is paid from the stream of interest payments made on mortgage loans by a pool of homeowners. Thus, prepayment of mortgage loans by members of the pool tends to diminish or extinguish the yield on the related IO. The rate at which mortgages are paid off increases more than expected if interest rates on mortgage loans decline unexpectedly prompting an unanticipated higher number of homeowners to refinance. Given these characteristics, IOs can result in significantly greater price and yield volatility than traditional debt securities. See *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 6 (2d Cir. 1996), *cert. denied*, 117 S. Ct. 2433 (1997). In addition, however, IOs can serve as a hedge to

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1. In 1991, six investment managers handled the Fund's assets. During that year, ANB managed approximately $170 million of the Fund's fixed-income account and $130 million of the Fund's equity account. The $11 million IO investment represented 6.5 percent of the Fund's fixed-income account managed by ANB and 3.7 percent of the Fund's total portfolio managed by ANB.

prevent significant losses in value due to interest rate changes because IOs generally increase as interest rates rise and mortgage-backed securities generally decline as interest rates rise. *Id.* at 3-4.

The Fund and the Trustees sued ANB in 1995 for breach of fiduciary duties pursuant to ERISA. Following a bench trial, the district court determined that (1) ANB failed to consider the Fund's investment guidelines or whether IOs would violate the spirit of the guidelines; (2) ANB's investment in IOs was not consistent with the Fund's stated guidelines; and (3) a prudent investment manager would not consider IOs an appropriate investment for the Fund in light of the Fund's guidelines. In its written opinion, the district court stated that "[i]t does not matter that other investment consultants in the industry held the opinion that IOs were appropriate for modern investment portfolios or that the portfolio as a whole made an adequate return." Based on a conclusion that ANB failed to fulfill its fiduciary duties, the district court awarded the Trustees $7,161,549 in damages. ANB filed a notice of appeal, after which the district court entered an amended final judgment awarding the Trustees $281,937 for prejudgment interest and $398,384 for attorneys' fees.

Standards of Review

The district court's findings and inferences of fact are reviewed under the clearly erroneous standard, and its interpretations and applications of law are reviewed de novo. *Metzler v. Graham*, 112 F.3d 207, 209 (5th Cir. 1997); *Reich v. Lancaster*, 55 F.3d 1034, 1044-45 (5th Cir. 1995).

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Discussion

ERISA was enacted to regulate employee benefit plans and protect the funds invested in such plans. 29 U.S.C. § 1302(a). ERISA assigns to plan fiduciaries "a number of detailed duties and responsibilities, which include 'the proper management, administration, and investment of [plan] assets, the maintenance of proper records, the disclosure of specified information, and the avoidance of conflicts of interest.' " *Mertens v. Hewitt Associates*, 508 U.S. 248, 251-52, 113 S. Ct. 2063, 124 L.Ed.2d 161 (1993) (citation omitted).

In ERISA, "[r]ather than explicitly enumerating all of the powers and duties of trustees and other fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility."[2] *Central States, Southeast and Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559, 570, 105 S. Ct. 2833, 86 L.Ed.2d 447 (1985). The manner in which trustees and other fiduciaries may exercise their powers, however, is further defined in the statute through the provision of strict standards of conduct, also derived from the common law of trusts — most prominently a standard of loyalty and a

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2. Traditionally, fiduciaries have abided by the common law of trusts which held that the riskiness of each investment in a portfolio must be measured in isolation. Leslie J. Bobo, Comment, *Nontraditional Investments of Fiduciaries: Re-Examining the Prudent Investor Rule*, 33 Emory L.J. 1067, 1078 (1984); *see also Chase v. Pevear*, 419 N.E.2d 1358, 1366 (Mass. 1981) and *In re Bank of New York*, 323 N.E.2d 700, 703 (N.Y. 1974) (stating that under common law, trustee must exercise prudence in making each investment and is chargeable with any loss for failing to do so).

standard of prudence. *Id.* at 570-71 (citing 29 U.S.C. § 1104(a)(1)(A) ("a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan") and 29 U.S.C. § 1104(a)(1)(B) (a fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims")).

In determining compliance with ERISA's prudent man standard, courts objectively assess whether the fiduciary, at the time of the transaction, utilized proper methods to investigate, evaluate and structure the investment; acted in a manner as would others familiar with such matters; and exercised independent judgment when making investment decisions. *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.), *cert. denied sub nom.*, 469 U.S. 1072 (1984). " '[ERISA's] test of prudence . . . is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed.' " *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984). Thus, the appropriate inquiry is "whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment." *Donovan v. Mazzola*, 716 F.2d 1226, 1232 (9th Cir. 1983), *cert. denied*, 464 U.S. 1040 (1984).

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The Secretary of Labor may prescribe such regulations as he finds necessary to carry out the provisions of ERISA. 29 U.S.C. § 1135. In 1979 the Secretary prescribed regulations under ERISA further defining a fiduciary's investment duties. 29 C.F.R. § 2550.404a-1. In general, the regulations provide that the fiduciary shall be required to act as a prudent investment manager under the modern portfolio theory rather than under the common law of trusts standard which examined each investment with an eye toward its individual riskiness. Specifically, they state that a fiduciary's investment duties under 29 U.S.C. § 1104(a)(1)(B) are satisfied if he has given appropriate consideration to facts he knows or should know to be relevant to the particular investment or investment course of action involved, "including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties" and has acted accordingly. 29 C.F.R. § 2550.404a-1(b)(1)(i)-(ii). For these purposes, "appropriate consideration" includes determining that the investment or investment course of action "is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action," and consideration of the following factors: "(A) The composition of the portfolio with regard to diversification; (B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and (C) The projected return of the portfolio relative to the funding objectives of the plan." 29 C.F.R. § 2550.404a-1(b)(2)(i)-(ii).

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In investments, the term "derivative" refers to "financial instruments whose performance is derived in whole or in part from the performance of an underlying asset (such as a security index of securities)." *See BNA Pension Benefits Report* No. 23, at 1046 (Apr. 15, 1996) (citing Department of Labor-Comptroller Letter of Guidance and Statement on Derivatives signed by Assistant Labor Secretary Olena Berg on Mar. 28, 1996). Examples of these financial instruments include futures, options, options on futures, forward contracts, swaps, structured notes and collateral mortgage obligations, and interest-only and principal-only strips. *Id.*; David R. Levin & Tess J. Ferrera, *ERISA Fiduciary Answer Book* 7-73, 7-74 (3d ed. 1998). In the Letter of Guidance and Statement on Derivatives, the Department of Labor and the Comptroller made the following statements:

> Investments in derivatives are subject to the fiduciary responsibility rules in the same manner as are any other plan investments . . . . In determining whether to invest in a particular derivative, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This would include, but not be limited to, a consideration of how the investment fits within the plan's investment policy, what role the particular derivative plays in the plan's portfolio, and the plan's potential exposure to losses.

* * *

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> Plan fiduciaries have a duty to determine the appropriate methodology used to evaluate market risk and the information which must be collected to do so. Among other things, this would include, where appropriate, stress simulation models showing the projected performance of the derivatives and of the plan's portfolio under market conditions. Stress simulations are particularly important because assumptions which may be valid for normal markets may not be valid in abnormal markets, resulting in significant losses . . . .
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> * * *

Investment managers are also charged with making investments in accordance with documents and instruments governing the plan insofar as the plan documents are consistent with the provisions of ERISA. 29 U.S.C. § 1104(a)(1)(D). The Fund investment guidelines in the present case, in pertinent part, provide:

> 1. Investments are limited to holdings which would be permitted under the prudent man rule as set forth in the Employee Retirement Income Security Act of 1974.
>
> * * *
>
> 4. Bond investments shall be limited to Federal or Federal Agency obligations or corporate bonds of the first three quality grades (at the

> time of purchase) as established by one or more of the nationally recognized bond rating services . . . .
>
> 5. The investment managers are not authorized to engage in investment transactions involving stock options, short sales, purchases on margin, letter stocks, private placement debt, commodities, venture capital. Future investments in foreign securities will not be made without prior consultation with, and approval by, the Board of Trustees . . . .

The parties treated the Pension Fund Investment Philosophy and General Policy on Investments as part of the plan documents. The Investment Philosophy, in pertinent part, provides:

> The Trustees of the Laborers National Pension Fund, in order to protect the interests of the participants and beneficiaries for the purpose of providing them with benefits and defraying the reasonable expenses of administering the Plan, are committed to protect the corpus of the Fund, meet the actuarial assumptions, and comply with applicable Federal and state laws. In order to accomplish these goals in a prudent manner, the Trustees believe that the investments of the Fund must be diversified among government securities, bonds, mortgages, common stock, real estate, insurance company contracts, money market instruments, and other appropriate investments.

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> Therefore, it will be the policy of the Trustees to invest the assets of the Fund with care in those vehicles which should preserve the principal while recognizing the need for income and appreciation with a minimal risk. This policy will be carried out by the Trustees in a prudent manner with the assistance of reputable professional money managers, consultants, insurance companies and banks to make the investments. The performance of these investments will be reviewed at least quarterly using various evaluation techniques that prove reliable and face-to-face discussion and review among the parties . . . .

And the General Policy on Investments, in pertinent part, states that:

> a) It is the intention of the Board of Trustees to allow the investment manager full discretion within the scope of the agreed upon investment guidelines and restrictions. The manager's performance in meeting the Fund's objectives will be reviewed on a regular periodic basis. Results based on a total rate of return (including both realized and unrealized gains and losses) will be evaluated quarterly by a professional service retained by the Trustees.
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> * * *
>
> c) All investment managers will be providing quarterly reports to the Trustees in the

requested format. The reports include a review of previous actions, current status of the portfolio, recommendations, etc. If changing market or economic conditions or other events suggest that a special meeting or action of the Trustees is necessary it is expected that the manager will communicate with the Trustees promptly rather than waiting for submission of the scheduled report.

d) If in the judgment of the investment manager strict adherence to one or more of the following investment guidelines in connection with a specific transaction is not in the best interests of the Laborers National Pension Fund or would produce an undesirable investment result the manager shall consult with the Trustees before proceeding with the transaction.

The district court clearly erred in determining that ANB failed to consider Fund guidelines before purchasing IOs. During the period at issue, Tom Pierce was ANB's Director of Fixed Income. Before Mr. Pierce authorized the purchase of IOs in 1991 he and his ANB associates consulted the ANB documents that incorporated the Fund guidelines, reviewed general literature on IOs and discussed the merits of investing in IOs with brokers. Mr. Pierce also utilized electronic Bloomberg stress simulation models to project the performance of IOs and the Fund's portfolio under market conditions. The Bloomberg stress simulation models based their projections on the prepayment histories of various

securities based upon interest rate changes. Mr. Pierce considered the whole universe of investment grade, fixed-income alternatives and evaluated the risks and rewards associated with these securities relative to a Lehman Brothers Aggregate Index.

Not only did Mr. Pierce consider the risks associated with IOs in the context of the goals of the Fund; ANB also convened an Account Review Committee which met quarterly to review client objectives and to ascertain whether ANB's investment decisions complied with these objectives. ANB invested in IOs on behalf of several pension plans covered by ERISA and the Account Review Committee approved the use of IOs in the Fund's fixed-income account prior to their purchase. In addition, Standard Valuations, the company retained by the Trustees to be responsible for monitoring ANB's compliance with the Fund guidelines, considered the IO investment permissible under the Fund guidelines. In fact, at least one other investment manager, Lazard Freres, made an IO investment for the Fund under the same investment guidelines during the same period of time.

As we read the plan documents and instruments, ANB's investment in IOs was not a violation of the investment guidelines or their spirit. The documents and instruments governing the plan must generally be construed in light of ERISA's policies, and those documents cannot excuse either the trustees or the investment managers from their duties under ERISA. *Central States*, 472 U.S. at 568. In interpreting the provisions of plan documents and instruments such as the investment guidelines with this view, we are also guided

by the principles of trust law. *Firestone v. Bruch*, 489 U.S. 101, 111, 109 S. Ct. 948, 103 L.Ed.2d 80 (1989) (citing *Central States Southeast and Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559, 570 (1985)). As they do with contractual provisions, courts construe terms in trust agreements without deferring to either party's interpretation. " 'The extent of the duties and powers of a trustee is determined by the rules of law that are applicable to the situation, and not the rules that the trustee or his attorney believes to be applicable, and by the terms of the trust as the court may interpret them, and not as they may be interpreted by the trustee himself or by his attorney.' " *Firestone*, 489 U.S. at 112 (citing 3 William F. Fratcher, *Scott on Trusts* § 201, at 221 (1988)). "The terms of trusts created by written instruments are 'determined by the provisions of the instrument as interpreted in light of all the circumstances and such other evidence of the intention of the settlor with respect to the trust as is not inadmissible.' " *Firestone*, 489 U.S. at 112 (citing Restatement (Second) of Trusts § 4, Comment d (1959)). Giving the written words of the guidelines their plain meaning within the context of trust law principles and ERISA policies, we conclude that the guidelines neither expressly nor implicitly prohibit investments in IOs of the first three quality grades; and that there is no reasonable basis for reading such a prohibition into the plan documents.

On the other hand, we find the interpretation of the Fund guidelines by the district court and the Trustees to be unreasonable under the ordinary meaning of the words of the document and especially so in light of the ERISA policies and the principles of trust law. The Investment Philosophy

requires the Trustees to "protect the interests of the participants and beneficiaries for the purpose of providing them with [pension and other] benefits . . . protect the corpus of the Fund, meet the actuarial assumptions, and comply with applicable Federal and state laws . . . diversif[y] [investments] among government securities, bonds, mortgages, common stock, real estate, insurance company contracts, money market instruments, and other appropriate investments . . . [and] invest the assets of the Fund with care in those vehicles which should preserve the principal while recognizing the need for income and appreciation with a minimal risk." The Trustees contend that the last clause implies a ban against IOs because derivatives involve a risk of loss of principal. We do not think that ambiguous clause standing alone justifies such an inference. Reading it together with the balance of the Investment Philosophy and plan documents, we are certain that it does not. The clear words of the Investment Philosophy and other plan documents require the Trustees to invest in many types of assets involving the risk of loss of principal, such as common stocks, real estate, insurance contracts, and money market instruments. Indeed, the evidence indicates that the Fund's equity and fixed-income portfolios have long contained many investments having risk of principal losses. The goals of the plan are to provide sufficient growth in assets for the payment of future pensions and other benefits to large numbers of participants and beneficiaries and to protect the Fund against inflation and depreciation. These objectives dictate an investment policy of reasonable risk, healthy appreciation and appropriate diversification. ERISA and the federal regulations likewise impose prudent fiduciary duties of careful investments for the same purposes.

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The Fund guidelines expressly prohibit investments "involving stock options, short sales, purchases on margin, letter stocks, private placement debt, commodities [or] venture capital. . . ." IOs are not among the prohibited investments.[3] The Fund guidelines stated that investments should be limited to federal agency obligations or corporate bonds of the first three quality grades. The IOs at issue met this requirement, as they were rated "AAA" at the time of their purchase. Furthermore, the Investment Philosophy indicated that investments should be diversified among "government securities, bonds, mortgages, common stock, real estate, insurance company contracts, money market instruments, and other appropriate investments." ANB's investment in IOs was reasonably designed as part of the Fund's portfolio to further the purposes of diversification as a hedge against possible interest rate hikes and consequent declines in values of fixed income securities.

The Fund's general policies further provide that investment managers are given full discretion to make decisions within the scope of the Fund guidelines and that the results of their investment decisions would be evaluated quarterly by a professional service retained by the Trustees based on a total rate of return. The Trustees retained Standard Valuations for this purpose. The general policies also directed

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3. In 1994, the Trustees revised the Fund guidelines, adding IOs to the list of prohibited investments. The Fund's counsel advised that the Fund guidelines should specifically state how mortgage-backed securities were to be treated. The fact that the Trustees and the Fund's counsel recognized the need to revise the guidelines indicates that the guidelines did not prohibit this type of investment when ANB purchased the IOs.

ANB to provide quarterly reports to the Trustees in a requested format reviewing previous actions, current portfolio status, and recommendations. There is no contention that ANB failed to cooperate with Standard Valuations in its evaluations or failed to file its own quarterly reports, properly disclosing detailed information concerning fund investments and management.

The Trustees argue that ANB breached its obligation to consult with them prior to the IO investment. On the contrary, however, the Fund guidelines and supporting documents require investment managers to consult with the Trustees and obtain prior approval of an individual investment in only two instances: (1) future investments in foreign securities; and (2) if in the judgment of the investment manager strict adherence to the guidelines in connection with a specific transaction is not in the best interests of the Fund or would produce an undesirable investment result. The Trustees do not contend that the IOs involved foreign securities. ANB considered the purchase of the small quantity of IOs to be a prudent investment within the portfolio designed as a hedge and to produce a desirable result for the portfolio as a whole. Therefore, because in the investment manager's judgment the IO investments were in the best interest of the Fund, ANB was not required to obtain prior approval of those investments.

In support of its conclusion that IOs were inconsistent with the Fund guidelines, the district court stated: "It does not matter that other investment consultants in the industry held the opinion that IOs were appropriate for modern investment portfolios or that the portfolio as a whole made

an adequate return." This statement indicates that the district court erroneously judged the IO investment in isolation under the common law trust standard, instead of according to the modern portfolio theory required by ERISA policy as expressed by the Secretary's regulations. The district court's reasoning, which the Fund urges again in its argument, is clearly at odds with ERISA and the regulations. A fiduciary may not discharge his duties in a manner inconsistent with ERISA provisions. 29 U.S.C. § 1104(a)(1)(D); *see also Gruby v. Brady*, 838 F. Supp. 820, 829 (S.D.N.Y. 1993) ("ERISA section 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D), requires fiduciaries to discharge their duties in accordance with plan documents only 'insofar as such documents and instruments are consistent with the provisions of [ERISA].' "). Since 1979, investment managers have been held to the standard of prudence of the modern portfolio theory by the Secretary's regulations. 29 C.F.R. § 2550.404a-1; Bobo, *supra*, at 1078. In case of a conflict, the provisions of the ERISA policies as set forth in the statute and regulations prevail over those of the Fund guidelines. There is no conflict in the present case because the plan documents do not require that the prudence of the IO investments be judged in isolation, as the district court and the Trustees suggest. If they did, the plan documents and guidelines would be forced to yield to the regulations' requirement that the investment be reasonably designed as part of the portfolio to further the purposes of the plan.

Under a proper application of the correct legal principles to the evidence in the present case, there is not a reasonable basis for concluding that ANB or Mr. Pierce acted imprudently or in violation of their fiduciary responsibilities

with regard to the 1991 investments in IOs. ANB considered the characteristics of IOs and utilized stress simulation models to project the performance of IOs and the Fund's portfolio under various market conditions before investing in IOs. The Fund's expert witnesses, none of whom were active or experienced ERISA plan investment managers, failed to point out any specific violation by Mr. Pierce or ANB of a fiduciary duty required by the prudent investor and modern portfolio standards of ERISA and the related federal regulations and guidance. Instead, the Fund's experts based their opinions that ANB's IO investments were imprudent on analysis of those investments standing alone, in isolation from the relevant portfolio. Also, despite their ultimate conclusions, one or more of the Fund's expert witnesses conceded that IOs can serve as a hedge against countervailing risks of a portfolio, the Fund guidelines did not prohibit the investment in IOs, the investment community did not anticipate the sudden, unprecedented decrease in interest rates which accelerated the prepayment of mortgages in 1992, and Mr. Pierce sufficiently investigated the available data on the nature of the particular IOs prior to purchasing them.

ANB's expert witness, Mr. Henderson, an experienced ERISA plan investment manager, testified that ANB's IO investments were not imprudent when analyzed under the prudent investor, modern portfolio principles of ERISA and the pertinent Department of Labor regulations and guidances. He was the only expert witness who properly assessed ANB's IO investments as of the time they were made using the correct prudent man, modern portfolio ERISA principles. Mr. Henderson testified that in forming his opinion, he reviewed

the quarterly reports issued by ANB to the Fund in 1991 and 1992; the data on the pertinent IOs available to ANB prior to the 1991 IO investments; the portfolio and investment goals and guidelines; and Standard Valuations' assessment of ANB's IO investments and overall performance for 1992. Based upon the Fund guidelines, the economic conditions that prevailed in September 1991, the makeup of the Fund's portfolio and Mr. Pierce's objectives for the portfolio, Mr. Henderson concluded that the IO investments were appropriate.

From our review of the record, we conclude that the Trustees failed to produce evidence from which it reasonably could be found that Mr. Pierce or ANB acted imprudently or that the IO investments in the present case violated the guidelines or ERISA policies. Accordingly, we REVERSE the district court's judgment in favor of the Trustees and RENDER judgment in favor of the defendants-appellants and against the plaintiffs-appellees.

APPENDIX B — FINDINGS OF FACT AND CONCLUSIONS OF LAW OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF TEXAS, DALLAS DIVISION DATED AND FILED AUGUST 15, 1997

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

No. 3:95-CV-2504-T

LABORERS NATIONAL PENSION FUND, et al.,

Plaintiffs,

v.

ANB INVESTMENT MANAGEMENT AND TRUST COMPANY, and THE FIRST NATIONAL BANK OF CHICAGO,

Defendants.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This action came before the Court, Honorable Robert B. Maloney, presiding, on a non-jury trial concluded January 23, 1997. After considering the argument and evidence presented at trial and the post-trial briefs, the Court makes the following findings of fact and conclusions of law. The Court reserves the right to enter more specific findings of fact and conclusions of law should the Court consider it necessary.

Appendix B

Introduction

This action is brought by an employee pension trust fund and its governing board of directors against its professional pension investment management firm, a national bank together with its wholly owned subsidiary, which the trust fund employed to invest certain of its assets and manage these investments on an ongoing basis. Plaintiffs allege that by making certain investments in derivative securities with the pension fund's assets, Defendants breached their fiduciary duties to the pension fund and violated the statutory standards of conduct imposed on Defendants by the Employee Retirement Income Securities Act, 29 U.S.C. § 1001, *et seq.* Plaintiffs seek to recover more than $7,000,000 in restitution.

Defendants admit that several of its investment choices did not perform as expected. Nevertheless, Defendants contend that they did not violate any fiduciary duties by investing in a class of security known as interest-only strips. Defendants assert that risks are inherent in any individual investment, which is why they properly diversified the fund's portfolio. Defendants contend that the portfolio, when viewed as a whole, performed adequately. They contend that the use of interest only strips as a "hedge" was a proper business decision based on the information available to them at the time the investments were made.

Findings of Fact

1. Plaintiff Laborer National Pension Fund is an "employee pension benefit plan," and "employee benefit plan," and a "multi-employer plan," as those terms are defined by ERISA.

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2. The purpose of the Pension Fund is to provide retirement income to construction industry laborers and other workers employed in Texas and other southern and central states. Currently, 15,000 retirees and beneficiaries receive pension benefits from the Pension Fund, and another 16,000 active workers are covered and earning benefit rights under the Pension Fund.

3. Plaintiffs Bill L. Harbert, Sr., Arthur A. Coia, Bruce Hughes, R.P. Vinall, Robert D. Sheehan, Mason Warren, Billy Harbert, Jr., and Carl Booker, are Trustees of the Pension Fund and collectively constitute the Board of Trustees which is responsible under the Agreement and Declaration of Trust establishing the Pension Fund for governing, operating, and managing the fund. The Trustees are volunteers and are drawn from the ranks of present or retired executives of contributing employers and union officials.

4. Defendant American National Bank and Trust Company of Chicago is a national banking association.

5. Commencing in 1971 and continuing until 1994, the Pension Fund and American were parties to an agreement for the provision of professional investment management services to the Pension Fund.

6. In or about 1988, American created ANB as a wholly-owned subsidiary out of its existing division known as the Investment Management Group (IMG).

7. Defendant ANB Investment Management and Trust Company is a for-profit company engaged in the business of

managing the investments of pension funds and other institutional investors.

8. Officers of IMG who were transferred to ANB also remained officers of American. IMG employees and officers transferred to ANB continued to perform the same investment management functions for the Pension Fund as they had before ANB's creation.

9. In or about 1994, American sold ANB to the First National Bank of Chicago, a "sister" bank owned by the same holding company as American.

10. American was vested by the Pension Fund's Board of Trustees with discretionary control over the investment and re-investment of certain Pension Fund assets, subject to certain guidelines set by the Board of Trustees and to the fiduciary standards of ERISA.

11. The 1971 investment management agreement between the Pension Fund and ANB authorized ANB to invest the Pension Fund's assets in such securities, "as in its absolute discretion it deems suitable, utilizing all available counsel it deems appropriate and necessary, but within the framework of an investment policy approved by the trustees."

12. The contract required ANB to submit to the Trustees a written statement as to the long range investment policy it proposed to follow and to "act within the boundaries of this policy until such time as the Trustees advise, in writing, that they no longer desire to follow such policy, or until the original policy has been replaced with a new and revised policy statement."

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13. From the inception of the relationship, it was understood that the Trustees had a very low tolerance for risk of loss of principal, particularly with regard to fixed income investments. As early as 1975, the Trustees directed ANB to report to them whenever a loss of 10% or more was incurred on an individual security.

14. In 1976, the Trustees adopted a written set of investment guidelines. The guidelines limited the investment discretion of ANB and other investment managers retained by the Pension Fund.

15. The guidelines stated that, "[I]t will be the policy of the Trustees to invest the assets of the Fund with care in those vehicles which should preserve the principal while recognizing the need for income and appreciation with minimal risk."

16. The investment guidelines required that all investments fall within either of two classes: (1) "federal or federal agency obligations," or (2) corporate bonds of the highest three quality grades. The guidelines did not specifically prohibit interest-only strips.

17. The Trustees relied on ANB to help keep the investment guidelines updated and to apprise the Trustees of any changes in the investment market that might affect the appropriateness of the guidelines.

18. In 1991, ANB used $11,000,000 of the Pension Fund's assets to purchase for the Pension Fund's fixed income account three derivative investments known by the industry

as stripped interest-only mortgage-backed securities. In 1992, ANB sold these IOs at a price that caused the Pension Fund to realize a loss of about 40% of the principal invested.

19. IOs were invented in the late 1980s. They are created by dividing the stream of principal and interest payments made by homeowners whose mortgages are included in a fixed pool of mortgages. Investors holding IOs are entitled to share only in the interest portion of the mortgage payments flowing through the pool. The principal portion of the mortgage payments are shared by investors holding other types of securities.

20. When homeowners refinance or otherwise repay their mortgages in the pool, the stream of interest payments on those mortgages ceases and is not replaced by additional mortgages. Accordingly, as the mortgages on the pool are prepaid, the stream of payments to which IOs are entitled decreases and will cease altogether when all the mortgage pools are paid off.

21. IOs are interest-rate sensitive. As interest rates for mortgage loans decline, the rate at which mortgages in a pool are paid off increases as homeowners refinance their mortgages to take advantage of the lower rates. The deeper the decline in interest rates, the faster will be the rate of prepayment of mortgages.

22. In addition to interest rates, other factors, such as changes in tax laws or changes in the way mortgages are structured can increase the risk of prepayment.

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23. Some IOs are issued by federal agencies and the repayment of these mortgages are guaranteed by these agencies against default; however, no government agency guarantees that interest will be paid until the maturity date of the mortgages.

24. At the time ANB purchased the IOs, the Trustees were unaware of the invention of IOs and were unfamiliar with the risks associated with them.

25. ANB did not advise the Trustees about the risks associated with the purchase of IOs. The Trustees learned about the risks associated with IOs only after they realized a loss.

26. ANB had the opportunity to discuss with the Trustees the risks and benefits of investing in IOs. ANB failed to take advantage of this opportunity.

27. The person responsible at ANB for purchasing the IOs, Tom Pierce, failed to consider the investment guidelines or whether IOs would violate the spirit of those guidelines. Had Pierce properly disclosed the risks associated with IOs to the Trustees, they would have, in all likelihood, specifically excluded them.

28. Pierce did not believe that clients in general could adequately assess their own needs or state them in a manner consistent with "cutting-edge" modern portfolio theory.

29. Maintaining a diverse portfolio is the standard in the fund-management industry.

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30. It is appropriate and desirable in certain circumstances to purchase investments that perform well in different economic climates. For example, some investments perform well in times of high interest rates, while others perform well in times of low interest rates. Purchasing both types of investments at the same time to offset risk is known as "hedging." Using proper hedging techniques, investment managers may make investments which, taken individually, are considered to be of moderate to high risk, but when considered together are considered to be of relatively low risk.

31. In certain limited circumstances, IOs may be properly used to hedge other investments. In this case, the evidence does not show that IOs were being used to hedge. Rather, the evidence shows, and the Court so finds, that the IOs were purchased because Pierce was convinced that interest rates would continue to rise.

32. Other investment vehicles are available that may serve as a hedge without the same risk of loss to principal.

33. IOs are not directly equivalent to "junk bonds" in terms of bond ratings. A junk bond is a bond that has a rating below the first four bond-quality grades. Nevertheless, in terms of risk to the principal investment, the Court deems investment in IOs to be equal to or more risky than junk bonds.

34. During the period when the relevant IOs lost money, unusual and unexpected economic conditions prevailed. Many experts in the industry made the same or similar predictions as Pierce.

35. At the time the investments were made, Pierce had enough information available to him to know that a complete loss of principal was possible if his predictions did not come true.

36. Investing in IOs was inappropriate and inconsistent with the purpose of the plan and the wishes of its participants. Under the facts of this case, a prudent investment manager would not consider the maximum rate of return on the IOs purchased, which was about the same as other low to moderate risk investments in which the principal is guaranteed, as justifying the risk of a total loss of principal.

37. Although the loss to the individual investments was substantial, it appears that the portfolio managed by Pierce performed at an adequate or average level when considered as a whole. Nevertheless, investment in IOs was not consistent with the Trustees' stated guidelines.

38. Plaintiffs' expert on damages testified that the net loss to the Pension Fund $7,161,548.91. The Court finds the expert's testimony credible, relevant, and based on accepted and sound economic and accounting principles. Defendants failed to produce any credible testimony to rebut this calculation.

39. The Court finds that Plaintiffs have established, by a preponderance of evidence, that Defendants breached their fiduciary duty and that this breach proximately caused them injury in the amount of $7,161,548.91.

40. The evidence showed that the Trustees desired, in addition to a risk-adverse portfolio, that the individual

investments meet a minimum threshold of principal security. Pierce did not appear concerned with this desire. His attitude was that clients often did not understand what was in their best interests.

41. Clients have a right to determine what risks they are willing to take. The evidence shows that IOs were a new and exotic investment vehicle. Under the facts of this case, it would be unreasonable to rule that the Trustees should have specifically excluded IOs from the portfolio.

42. A prudent investment manager would not consider this type of investment appropriate for the Pension Fund in light of the Pension Fund's guidelines. It does not matter that other investment consultants in the industry held the opinion that IOs were appropriate for modern investment portfolios or that the portfolio as a whole made an adequate return. The evidence does not show that the Trustees were properly apprised of the unique risks associated with IOs so that they could have the opportunity to specifically exclude them if they so desired and the evidence in this case indicates that they would have.

Conclusions of Law

1. The Court has federal question subject matter jurisdiction over this action because Plaintiffs' claims arise under the laws of the United States. 28 U.S.C. § 1331. No defendant has asserted a legitimate objection to the personal jurisdiction of this Court. Venue is proper.

2. The Pension Fund is covered by ERISA. 29 U.S.C. § 1003.

3. Plaintiffs Bill L. Harbert, Sr., Arthur A. Coia, Bruce Hughes, R.P. Vinall, Robert D. Sheehan, Mason Warren, Billy Harbert, Jr., and Carl Booker, are fiduciaries with respect to the Pension Fund. 29 U.S.C. §§ 1002(21). They are authorized by statute to bring suit on behalf of the fund. 29 U.S.C. § 1132(a) & (b).

4. Because standing is a jurisdictional prerequisite to the court entering judgment in a party's favor, it has the obligation to raise the issue sua sponte. FED. R. CIV. P. 12(h)(3); *Bender v. Williamsport Area Sch. Dist.*, 475 U.S. 534, 546-57 (1986).

5. Although the Pension Fund itself has the capacity to sue and be sued as an artificial entity, 29 U.S.C. § 1132(d)(1), it lacks standing to bring claims under ERISA's enforcement provisions because it is neither a "participant," "beneficiary," or "fiduciary," as defined by ERISA. *See Coleman v. Champion Intern./Champion Forest Prod.*, 992 F.2d 530, 533 (5th Cir. 1993).

6. ANB was at all relevant times a fiduciary with respect to the Pension Fund. 29 U.S.C. § 1002(21)(A).

7. As a fiduciary, ANB was required to perform its investment management responsibilities in accordance with ERISA's "prudent man" standard of fiduciary conduct as set forth in 29 U.S.C. § 1104(a).

8. These fiduciary duties are the "highest known to the law." *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2nd Cir. 1982). In the ERISA context, fiduciaries have a duty to inquire into

the particular needs of a plan and its participants. *Lanka v. O'Higgins*, 810 F. Supp. 379, 388 (N.D.N.Y. 1991).

Reasons for Judgment

Defendants breached their fiduciary duty to Plaintiffs. Plaintiffs are entitled to recover damages proximately caused by this breach. The Court will enter judgment according to the findings of fact and conclusions of law.

Plaintiffs request an award of prejudgment interest and attorneys' fees. The Court will not address these issues at this time. Plaintiffs may move for an award of prejudgment interest pursuant to Rule 59 and attorneys fees pursuant to Rule 54(d). The Court deems the briefing on the issue of prejudgment interest to be insufficient to award it at this time.

Signed this 15th day of August, 1997.

s/ Robert B. Maloney
Robert B. Maloney
U.S. District Judge

APPENDIX C — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT DENYING PETITION FOR REHEARING DATED AND FILED JUNE 16, 1999

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 97-11023

LABORERS NATIONAL PENSION FUND,
an employee pension benefit plan; et al

Plaintiffs

BILL L HARBERT, Board of Trustee; ARTHUR A COIA, Board of Trustee; BRUCE HUGHES, Board of Trustee; R P VINALL, Board of Trustee; ROBERT D SHEEHAN, Board of Trustee; MASON M WARREN, Board of Trustee; BILLY L HARBERT, JR, Board of Trustee; CARL E BOOKER, Board of Trustee

Plaintiffs – Appellees

v.

NORTHERN TRUST QUANTITATIVE ADVISORS, INC., a corporation; THE FIRST NATIONAL BANK OF CHICAGO, a corporation; AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO, a corporation

Defendants

Appendix C

NORTHERN TRUST QUANTITATIVE ADVISORS, INC., a corporation; AMERICAN NATIONAL BANK AND TRUST COMPANY OF CHICAGO, a corporation

Defendants – Appellants

Appeal from the United States District Court for the Northern District of Texas, Dallas

ON PETITION FOR REHEARING AND REHEARING EN BANC

(Opinion 4/16/99, 5 Cir., __, __ F.3d __)

Before EMILIO M. GARZA, BENAVIDES and DENNIS, Circuit Judges.

PER CURIAM:

(X) The Petition for Rehearing is DENIED and no member of this panel nor judge in regular active service on the court having requested that the court be polled on Rehearing En Banc, (FED. R. APP. P. and 5TH CIR. R. 35) the Petition for Rehearing En Banc is also DENIED.

* * *

ENTERED FOR THE COURT:

s/ [illegible]
United States Circuit Judge

APPENDIX D — RELEVANT STATUTE AND REGULATION

29 U.S.C.A. § 1104

§ 1104. Fiduciary duties

(a) Prudent man standard of care

(1) Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

* * *

29 C.F.R. § 2550.404a-1

§ 2550.404a-1 Investment Duties.

(a) In general. Section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974 (the Act) provides, in part, that a fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

(b) Investment Duties.

(1) With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of section 404(a)(1)(B) of the Act set forth in subsection (a) of this section are satisfied if the fiduciary:

(i) Has given appropriate consideration to those facts and

circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and

(ii) Has acted accordingly.

(2) For purposes of paragraph (b)(1) of this section, "appropriate consideration" shall include, but is not necessarily limited to,

(i) A determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and

(ii) Consideration of the following factors as they relate to such portion of the portfolio:

(A) The composition of the portfolio with regard to diversification;

(B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(C) The projected return of the portfolio relative to the funding objectives of the plan.

(3) An investment manager appointed, pursuant to the provisions of section 402(c)(3) of the Act, to manage all or part of the assets of a plan, may, for purposes of compliance with the provisions of paragraphs (b)(1) and (2) of this section, rely on, and act upon the basis of, information pertaining to the plan provided by or at the direction of the appointing fiduciary, if —

(i) Such information is provided for the stated purpose of assisting the manager in the performance of his investment duties, and

(ii) The manager does not know and has no reason to know that the information is incorrect.

(c) Definitions. For purposes of this section:

(1) The term "investment duties" means any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in section 3(21)(A)(i) or (ii) of the Act.

(2) The term "investment course of action" means any series or program of investments or actions related to a fiduciary's performance of his investment duties.

(3) The term "plan" means an employee benefit plan to which Title I of the Act applies.

* * * *